No. 21795

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ESTATE OF EUGENE L. FREELAND, Deceased, by SECURITY FIRST NATIONAL BANK, a national banking association, Executor, and VERA GOOD FREELAND, by L. N. TURRENTINE, Conservator,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE

TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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I N D E X

CITATIONS

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (I-R. 114-151),[1/] are not officially reported.

1/ "I-R." references are to Volume I of the record on appeal. "II-R." references are to Volume II of the record on appeal.

JURISDICTION

The petition for review (I-R. 158-163) involves deficiencies in federal income tax for the taxable years 1956 to and including 1961 in the amount of $239,469.78. On July 29, 1964, the Commissioner of Internal Revenue mailed to the taxpayers a notice of deficiency asserting deficiencies in tax for the years 1956 to and including 1961 totaling $239,469.78. (I-R. 10-11.) Within ninety days thereafter, on October 19, 1964, the taxpayers filed a petition with the Tax Court for a redetermination of these deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-11.) The decision of the Tax Court was entered December 30, 1966. (I-R. 152.) The case is brought to this Court by a petition for review filed March 24, 1967 (I-R. 158-163), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTION PRESENTED

Whether the Tax Court was correct in deciding that a partnership had been holding land for sale to customers in the ordinary course of its trade or business.

STATUTES INVOLVED

The pertinent provisions of the statutes involved are set out in Appendix, *infra*.

STATEMENT

The facts relevant to this appeal, as found by the Tax Court (I-R. 115-134), some of which were stipulated, are substantially as follows:

Eugene L. Freeland and Vera Good Freeland[2/] are husband and wife. Margaret C. Lowthian is a single woman. Taxpayers reside in San Diego County, California, and they filed their respective tax returns for the years in question with the District Director of Internal Revenue at Los Angeles, California. (I-R. 115-116.)

From 1923 through the time of trial, taxpayer has been a full time civil and structural engineer living and working in San Diego County, California. He is licensed to practice by California and certain other states and has been and continues to be a member of numerous professional engineering associations and societies. During the years involved herein, he was a senior member of a civil engineering firm and a structural engineering firm. (I-R. 116.)

2/ The issues involved in this case all relate to transactions of Eugene L. Freeland, now deceased. His wife Vera is a party solely because joint returns were filed for the years in question. For convenience, all references will be to Eugene L. Freeland as the taxpayer.

Taxpayer's practice has included land surveying, the design of municipal improvements, the subdivision of land, and the design of buildings and structures. He rendered professional services in some of the larger real estate developments in the San Diego area and included among his clients some of the area's most active real estate subdividers and developers. Because of the rapid growth of San Diego County prior to and during the years in question, and because of his excellent reputation, taxpayer's practice has been financially successful. The growth of San Diego County has also resulted in a continuing and substantial appreciation in real estate values. (I-R. 116-117.)

Among the many land developers employing taxpayer and/or his civil engineering firm (hereafter referred to as the "engineering partnership") were George T. Forbes and Theodore M. Jacobs, doing business as Kensington Heights Company. In the late 1940's and again in 1951 and 1953, the engineering partnership rendered services to Kensington with respect to the so-called Waring Ranch property in the form of surveying the land, preparing boundary, topographical and master plan maps thereof, and representation before the City of San Diego Planning Commission and other city departments in its efforts to have the land annexed to the City of San Diego so as to make it more salable. Four hundred acres were annexed in 1951 and subsequently sold by Kensington. An additional 1,300 acres were annexed in 1952 or 1953 and sold by Kensington to Bollenbacher & Kelton, Inc.,

subdividers and developers. The engineering partnership was then employed by Bollenbacher & Kelton, Inc., to do the engineering work on the subdivision and development of the 1,300 acres. (I-R. 117.)

In 1953, efforts were made by Kensington to have the City of San Diego annex the remaining 4,500 acres. At the time of the annexation proceedings, the engineering partnership prepared a master plan map of the area, which indicated the lines along which development might feasibly proceed. The City of San Diego annexed the 4,500 acres in December of 1953. The 4,500 acres contained a lake, some canyons, and a mountain rising about 1,100 feet above the surrounding terrain. (I-R. 118.)

Shortly before the annexation, Kensington sought taxpayer's help in finding a buyer for the 4,500 acres. Taxpayer contacted several clients who were not interested because they thought that development and subdivision of the area was too remote in time. (I-R. 118.)

In April 1954, Kensington gave taxpayer a verbal option on the land. Taxpayer and one of his developer-clients, Sam Berger, decided to form a partnership to purchase the land. On August 6, 1954, they entered into an agreement to form the partnership, the terms of which were to be reduced to writing in the near future. Under the agreement, Berger was to enter into an escrow in his own name for the purchase of the land from Kensington. Before the close of the escrow, Berger was to nominate the partnership to take title to the land. (I-R. 118.)

Berger negotiated the terms for the purchase with Kensington. In the course of the discussions, Berger indicated that the whole

4,500 acres would be developed as soon as possible and that he had $20,000,000 in financing available, which was not in fact the case. Berger also told Kensington that the purchase price would be paid off in about three years. (I-R. 118-119.)

On August 6, 1954, Berger entered into an escrow agreement with Kensington. The agreement provided for a total consideration of $4,676,666.66 (computed on the basis of $800 per acre plus interest at 3-1/3 percent), payable $100,000 down and the balance in 20 annual installments. The purchase price was to be evidenced by an installment promissory note, the first installment of $180,000 to become due on August 6, 1955, with the remaining installments due annually thereafter in increasing annual amounts of $6,000 until the 19th installment in the amount of $288,000. The 20th and final installment was to be the remaining balance of $130,666.66. The escrow agreement contained provisions for the release of 150 acres against each annual payment, for the privilege of prepayments with appropriate adjustments for interest, and for the deposit by the purchaser of $200,000 to be disbursed for off-site improvements upon instructions from Kensington. (I-R. 119.)

The term "off-site improvements" comprehended two things: (1) the bringing of utilities, viz., water, sewer, gas, electricity, and telephone, from a point distant from the boundaries of the property being developed up to the boundaries of such property; and (2) the installation of a utility, e.g., a water main, on the property being developed, which utility is larger than required to serve such

property but which is nevertheless required by the City of San Diego in order to be available to serve further outlying property in the path of future development. With regard to these latter "off-site improvements," the city generally paid the difference between what the property being developed required and what the city insisted upon for purposes of future property development. (I-R. 119-120.)

Taxpayer provided $70,000 towards the $100,000 down payment. Berger borrowed the other $30,000 with taxpayer acting as guarantor of the loan. (I-R. 120.)

In the process of trying to raise the $200,000 deposit, taxpayer contacted the General Petroleum Corporation, seeking a loan. As part of the attempt to borrow the funds, a letter was sent on September 14, 1954, over taxpayer's signature, but without identification as to the capacity in which he was signing, to General Petroleum Corporation's representative in San Diego. The letter proposed that the corporation lend the necessary funds in exchange for exclusive service station sites within the contemplated 4,500-acre development. The letter also stated that a master plan for the development of the entire 4,500 acres was being completed and that it was proposed to start immediately the development of approximately 2,000 homes. The letter further stated that it was anticipated that a minimum of 4,000 homes would be constructed and occupied within three years and that, after the points involving financing the off-site improvements, completing the master plan, and selecting the location of the first 2,000 homes had been settled, consideration would be given to the sale of acreage to

subdividers capable of proceeding with the development in a satisfactory fashion. After due consideration, General Petroleum declined to provide any funds. (I-R. 120-121.)

After several unsuccessful attempts to raise the $200,000 from various other sources, Berger's associates in a development operation consisting of a joint venture of several corporations, known as "Country Club Park" (for which taxpayer individually acted as a consultant before various governmental agencies), agreed to put up the $200,000 for the off-site improvements. In return, this group (hereafter referred to as the "Barenfeld-Glaser Group") received a 20 percent interest in the Berger-Freeland partnership. (I-R. 121.)

On October 21, 1954, the Lake Murray Development Company, a California corporation (hereinafter referred to as "LMDC"), was incorporated for the purpose of subdividing and developing land and constructing homes thereon. LMDC was capitalized with funds that were advanced by the Barenfeld-Glaser Group. The stock of LMDC was held by Herbert Glaser, an attorney, as trustee for the benefit of the corporations which comprised the Country Club Park joint venture. Berger was the initial president of LMDC and Herbert Glaser was its secretary and attorney. Neither taxpayer nor Lowthian was an officer, director, stockholder, or investor in LMDC. Other principals included Sam Glaser, the father of Herbert, and Jack Barenfeld. (I-R. 121-122.)

Shortly after October 21, 1954, but prior to October 26, 1954, Sam Glaser and Jack Barenfeld caused $200,000 to be advanced by the Country Club Park joint venture to LMDC and thence from LMDC to the

Berger-Freeland partnership, Sam Berger Investment Company (hereinafter referred to as "SBIC"). On October 25, 1954, SBIC caused the $200,000 to be deposited in the escrow covering the purchase of the 4,500 acres. On October 26, 1954, the escrow was closed and title in the land was vested in SBIC subject to a deed of trust for the unpaid purchase price. (I-R. 122.)

On or about October 26, 1954, SBIC and LMDC entered into an option agreement, which was subsequently reduced to writing and executed on November 23, 1954. Partial consideration for this option was the fact that Sam Glaser and Jack Barenfeld had caused LMDC to provide the $200,000 to SBIC to enable it to close the escrow. The agreement gave LMDC an option to purchase 500 acres of land lying within a larger parcel of approximately 800 acres in the southeast corner of the property for a price of $2,000 per acre. (I-R. 122.) The option agreement further provided in pertinent part (I-R. 122-123):

(a) That SBIC was to release from the Kensington escrow a minimum number of acres per year in order to prevent a lapse of its right to continue to release acreage.

(b) That if LMDC purchased less than 150 acres per year under its option, SBIC had the right to sell the unpurchased difference.

(c) That LMDC realized that SBIC had an oral arrangement with "other subdividers" to purchase portions of the 800-acre parcel within which the 500 acres subject to the option was encompassed.

(d) That SBIC would cooperate with LMDC in filing the necessary maps and in expeditiously completing the building lots.

(e) That LMDC would submit to SBIC all its contracts with subcontractors for all items of work as so to guarantee that the cost would not exceed a certain minimum.

(f) That LMDC should be reimbursed by SBIC for expenses in excess of the stipulated maximum per lot cost of development, and SBIC would retain, as profit, any funds remaining in the trust fund established for lot development.

(g) That SBIC would be liable for all off-site improvement costs in excess of the $200,000 originally advanced by LMDC.

On November 23, 1954, the date on which the option agreement between SBIC and LMDC was signed, a formal limited partnership agreement was also executed by all of the general and limited partners in SBIC. This agreement was effective as of August 6, 1954. Under the terms of the agreement, taxpayer, with a 32 percent interest, and Berger, with a 20 percent interest, were the general partners. Margaret C. Lowthian, taxpayer's secretary and business associate, with an 8 percent interest, was taxpayer's designee and was a limited partner. The HAB Trust and the MLB Trust, each with a 10 percent interest, were Berger's designees and were limited partners. The final 20 percent was a limited partnership interest held under the name of Lake Murray Trust No. 1. The interests of the HAB Trust and the MLB Trust in SBIC were created by Sam Berger for his two sons, Harvey A. Berger and Marshall L. Berger. Sam Berger was the sole trustee of the HAB Trust and the MLB Trust. Neither the beneficiaries of these trusts, Harvey A. Berger and Marshall L. Berger, nor the

trusts themselves held any interest in LMDC. The 20 percent interest in SBIC, held under the name of Lake Murray Trust No. 1, was established for the benefit of Jack Barenfeld and Samuel Glaser. At a later date, Barenfeld and Glaser gave 10 percent of their interest in this trust to the other members of the Barenfeld-Glaser group. (I-R. 123-124.)

The preamble to the SBIC partnership agreement provided that the purpose of the partnership was to engage "in the business of buying, selling and developing land upon the real property commonly known as the Third Annexation of the Waring Property consisting of approximately four thousand five hundred (4500) acres of land in the City of San Diego, State of California." (I-R. 125.)

The body of the agreement provided, <u>inter alia</u> (I-R. 125-126):

(a) That the term of the partnership would be 10 years.

(b) That each partner, general or limited, was prohibited from selling, assigning, or transferring his interest in the partnership to any person other than another partner but that the agreement would subsequently be amended to resolve the question of the withdrawal or sale by the partners of a partnership interest.

(c) That taxpayer and Berger were to contribute $70,000 and $30,000, respectively, to the partnership but further that they could withdraw said sums from the first monies available to the partnership.

(d) The general business policy of said partnership in all questions relating to the management of its business should be determined by the mutual consent of the general partners.

(e) Both general partners were to have full management rights and control.

(f) Taxpayer was to receive an engineering fee of $25 per lot (in addition to any other engineering fees) from the first 2,000 lots "developed or sold by the partnership to third parties."

(g) That in the event the general partners could not agree, the problem would be submitted to arbitration.

After the closing of the Kensington escrow on October 26, 1954, Berger was anxious to get LMDC activated. The engineering partnership and taxpayer, as consulting engineer for LMDC, commenced applying for the necessary permits and talking with various city departments in ord to get necessary city approval. Taxpayer's engineering partnership was also employed by LMDC and performed various services for LMDC relating to on-site development and off-site improvements. (I-R. 126.

On November 8, 1954, taxpayer forwarded to the San Diego Plannin Commission on behalf of LMDC a "Tentative Map Unit No. 1 [Lake Park Development Property]." Unit No. 1 consisted of approximately 50 acres to be subdivided into approximately 260-280 lots. Submitted at the same time were ten copies of a master plan map for the entire 4,50 acres and ten copies of a master plan map of the 800 acres subject to LMDC's 500-acre option. The master plan map of the 4,500 acres was an identical copy of that prepared for Kensington and Mrs. Waring on October 23, 1953, except that a portion of the lower right-hand section of that map had been cut out and a new section representing Unit No. 1 inserted. The map for the 4,500 acres indicated tentative locations for schools, parks, and supermarkets

for the entire tract. It showed that, when fully developed, the 4,500 acres would yield an estimated 16,000 lots. As a result of discussions with representatives of SBIC and LMDC concerning approval of the subdivision plan, the representatives of the San Diego Planning Commission understood that Unit No. 1 was the first unit in a planned development that would ultimately total 4,500 acres. (I-R. 126-127.)

On November 4, 1954, LMDC purchased 3.19 acres by a partial exercise of its 500-acre option. LMDC then commenced construction of seven model homes on this acreage. It was necessary for LMDC to bring off-site improvements to the Lake Park Property's southeast border in order to develop this acreage. In late December 1954, the seven model homes were completed and opened to the public for inspection. The advertising campaign referred to a "City of Tomorrow" to be developed on the 4,500 acres. Taxpayer, though he was aware of such advertising, disapproved of it and so informed Berger. (I-R. 127.)

On December 14, 1954, the City Council, on the recommendation of the Planning Commission, gave preliminary approval to the subdivision plan for Unit No. 1. Prior to December 23, 1956, LMDC, through taxpayer, its agent, submitted to the City Planning Department a tentative subdivision map for Units Nos. 2 and 3. Prior to January 17, 1955, LMDC similarly submitted a tentative subdivision map for Units Nos. 4 and 5. The size of the lots ranged between one-fourth of an acre and one-fifth of an acre. It was anticipated that 500 acres would produce between 2,200 and 2,400 lots. Units

Nos. 1 through 5, if fully developed, would contain a total of approximately 3,000 lots and covered the 800-acre parcel on which LMDC had a 500-acre option. (I-R. 127-128.)

The city, in considering a tentative subdivision plan, was concerned, inter alia, with the location and adequacy of schools, parks, shopping centers, and off-site improvements, including adequate water supply. Though an immediate proposal might concern only a very small number of acres, the city considered the development in terms of overall plans for the surrounding area. The city would not permit wasteful duplication of facilities such as two small water reservoirs where one larger reservoir would be considerably more economical. (I-R. 128.)

Both Berger and taxpayer represented SBIC in negotiations with the San Diego Unified School District pertaining to the granting of options for school sites within Units 1 through 5. (I-R. 128.)

On March 8, 1955, SBIC, through a letter signed by Berger, offered the School District school sites at a price equal to $2,000 per acre plus "the average off-site cost for the entire 4,500 acres of approximately $200 per acre," plus the cost of on-site improvements Additional land for park and recreational purposes was offered on the same terms. This offer was not accepted by the School District. On September 23, 1955, SBIC, through a letter signed by Berger, offered the School District, for $1 each, options on school sites within Units 1 through 5 at $1,900 per acre for usable land. SBIC also agreed to give the School District renewable options on specific

sites of land selected by the School District on the remaining areas to be developed by SBIC. (I-R. 128-129.)

On July 26, 1955, the San Diego City Council adopted the Final Subdivision Map of College Ranch Unit No. 1, which map was filed and recorded in the County Recorder's Office on July 27, 1955. In July and August of 1955, LMDC partially exercised its 500-acre option and purchased an additional 146.93 acres from SBIC. LMDC then commenced development of Unit No. 1. LMDC also commenced the off-site improvement work for the 500-acre development. The principal aim in construction of these facilities was to provide adequate facilities for the 500 acres with minimum damage to the remaining 4,000 acres. (I-R. 129.)

In December 1954 or January 1955, a series of disputes arose between SBIC and LMDC. As a result of these disputes, LMDC and SBIC entered into an amended option agreement covering the 500 acres. The purchase price of the land was changed to $2,000 per acre for the first 250 acres and $1,800 per acre for all additional acreage. The "loan" of $200,000 by LMDC to SBIC was labelled a "credit," with LMDC entitled to recover any portion not used for off-site improvements, and no interest would be paid on the credit. LMDC's prior oral agreement to pay taxpayer $25 per lot for his personal service and counsel was reduced to writing. The agreement also eliminated the lot and off-site improvement cost guarantees by SBIC. (I-R. 129-130.)

LMDC engaged in the construction of 196 homes. By the summer of 1955, LMDC developed financial difficulties. In an attempt to remedy the situation, Berger sought a change in the amended option

agreement permitting LMDC to acquire what he thought would be more salable land. He proposed to develop land in the foothills of the mountain which would have a view of the lake. Employees of the engineering partnership prepared a feasibility study of the proposal, the conclusion of which was that the cost of off-site improvements would be prohibitive at that time. (I-R. 130.)

Ultimately, LMDC was unable to overcome its financial difficulties. It became insolvent on May 4, 1956. LMDC assigned to Phoenix Insurance Company of Hartford all of its assets, except that it retained the right under the amended option agreement to purchase 200 acres of land out of the 500 acres originally covered by the option. Since LMDC had already exercised its option to the extent of approximately 150 acres, the portion of the option assigned to Phoenix only covered the right to purchase the remaining approximately 150 acres. Phoenix subsequently exercised this option. (I-R. 130-131.)

Berger was blamed for mismanagement of LMDC and was himself in financial difficulty. In August 1956, Carlos Tavares, representing a group of developers, including himself, approached Berger and offered to purchase his interest in SBIC. Tavares had been one of the developers approached by taxpayer at the time of the annexation of the 4,500 acres. (I-R. 131.)

On August 10, 1956, the Tavares group agreed to buy out Berger's interest and the respective 10 percent interests of the HAB Trust and the MLB Trust in SBIC for $950,000. Berger did not get taxpayer's

consent for the sale of his interest in SBIC as required by the partnership agreement. (I-R. 131.)

Tavares then approached taxpayer in an effort to purchase his interest in SBIC or, in the alternative, to have taxpayer join the Tavares group in the development of the SBIC land. Taxpayer told Tavares he was not interested in joining in the development and decided to sell out. Taxpayer received $730,000 for his interest. In the agreement of sale, they consented to the purchase from Berger. (I-R. 131.)

During the taxable periods portions of the acreage were utilized for grazing and the raising of barley. The partnership reported gross income from these sources in 1955 of $10,467.99 against total expenses of $27,609.92 (of which $15,319.51 represented real estate taxes) and in 1956 of $17,958.50 against total expenses of $45,032.69 (of which real estate taxes represented $15,619.01). (I-R. 132.)

Taxpayer did not wish directly to engage in subdividing and developing the land, either individually or through any other business form, because it would place him in competition with his clients and those of his engineering partnership and thus be financially injurious. (I-R. 132.)

At no time material hereto was taxpayer individually a dealer in real estate or individually holding real estate for sale to customers in the ordinary course of business. (I-R. 132.)

Although no improvements were made directly to the acreage not covered by the option to LMDC, the entire tract benefited from the off-site improvements made by LMDC. SBIC itself never directly advertised, promoted, or otherwise engaged in active efforts to solicit for its land, nor did it authorize anyone to undertake such activities directly on its behalf. (I-R. 132.)

Taxpayer, on behalf of SBIC, refused several unsolicited offers for the sale of portions of the acreage not covered by the LMDC option. (I-R. 132.)

SBIC never purchased any real property except the 4,500 acres here in issue. The only sales of real property ever made by SBIC, aside from the 300 acres acquired under the 500-acre option to LMDC, were (1) the sale of a fractional acre to the telephone company and (2) the sale of approximately four acres to the City of San Diego for a reservoir site as required by Kensington when SBIC purchased the land. The only other land transactions of SBIC involved the grant to the San Diego School District of options to purchase sites within the area to be developed by LMDC for three elementary schools and one junior high school. SBIC also agreed to grant further similar options to the School District when development proceeded beyond the initial 500 acres. At the time of the annexation of the 4,500 acres, the city had required the then owners to agree to sell school sites within the property, and Kensington passed this obligation along to SBIC. (I-R. 133.)

Taxpayer reported gain on his sale of his partnership interest in SBIC on the installment basis as long-term capital gain. (I-R. 133

The tax as disclosed on taxpayer's 1956 return was $59,582.95. The Deficiency for 1956 was $93,332.32, the major portion of which represents the gain from the sale of taxpayer's partnership interest. (I-R. 133.)

The Tax Court found (I-R. 134) that SBIC held the land in question primarily for sale to customers in the ordinary course of its trade or business.[3/]

SUMMARY OF ARGUMENT

Although the sale of a partnership interest at a profit will generally result in capital gains treatment, the Internal Revenue Code provides that if the gain is attributable, in whole or part, to substantially appreciated inventory, then to that extent, the gain will be taxed as ordinary income. The question here is whether the land held by a partnership constituted inventory. Taxpayer contends the land was an investment while the Commissioner contends that the land was primarily held for sale to customers in the ordinary course of the trade or business, i.e., inventory.

When the partnership acquired this undeveloped land, it told the seller that the purchase price would be paid off in 3 years. It appears that the partnership would have had to sell the land in order to meet the annual installments of the purchase price because it had no other resources with which to make such payments. The seller of

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3/ Another issue before the Tax Court was whether the Commissioner had abused his discretion in reopening taxpayer's taxable year 1956, which had been previously audited and determining additional deficiencies for that year. The Tax Court held (I-R. 151) that the Commissioner had not abused his discretion. Insofar as taxpayer does not discuss this point in his brief, we assume that this point is conceded.

the land knew that the land would have to be improved before the land could be sold (the lack of improvements had caused the seller difficul in selling the land) and presumably to insure that such improvements would be made, required that the partnership deposit $200,000 in escro for such purpose. However, taxpayer testified that the partnership could not have developed the land, for such activity would have put him into open competition with developers in the area who were clients of his engineering firm. To overcome this problem, a corporation was set up in which taxpayer was not a stockholder but was a consultant. With the exception of taxpayer and his secretary, all the effective interests in the partnership were held by persons directly involved in the corporation. By virtue of this interlocking relationship, the partnership could insure development, without revealing taxpayer's participation, and as development would have progressed, the partnersh would have sold the land either to the corporation or to other developers. However, this plan never reached full maturity for after having made improvements to the land, constructing some model homes and advertising them for sale, the corporation became insolvent. Shortly thereafter, one of the two general partners sold his interest to a developer and then taxpayer sold his interest to the same developer at a gain.

Taxpayer's major contention is that relating the corporation's activities to that of the partnership's is not permitted because neither entity controlled the other. However, we submit that such argument lacks merit because it overlooks the realities of the situation. Contrary to taxpayer's contention, the facts readily revea

he inter-working of the two organizations, with the common objective f having the tract developed and sold. The corporation supplied the 200,000 for off-site improvements and in return, was given an option n 500 acres. The partnership guaranteed to pay all off-site costs in xcess of $200,000. Also, the partnership afterwards offered land to he school board in an apparent effort to enhance the value of the ract. Furthermore, the partnership had to have been assured that the orporation was going to exercise the option, for it, the partnership, as planning on using the proceeds of such a sale in order to meet the irst 5 installments on the purchase price. Equally revealing is that he corporation, although only the owner of 500 acres, advertised its odel homes as the forerunner of a City of Tomorrow to be built on the ,500 acres. Obviously then, both the partnership and the corporation ere involved in one project, namely, to have the entire tract eveloped and sold.

Taxpayer also contends that even if there was at one time a urpose to sell the land, such purpose changed. This argument--which s raised here for the first time--is predicated on the fact that the orporation became insolvent and went out of business. However, this act hardly requires a conclusion, as taxpayer urges, that the artnership's purpose automatically changed; it simply means that the artnership's plans for developing the tract and selling the land would ot be done with the aid of the corporation. Moreover, the record hows that shortly after the corporation's demise, 80% of the artnership was sold, an unlikely event if the partnership had decided, hen the corporation became defunct, to hold the property for nvestment, i.e., a long period of time.

The question is one of fact and should be reversed only if clearly erroneous. Insofar as there is ample evidence to support the Tax Court's finding that the land was held primarily for sale to customers in the ordinary course of business, it should be affirmed.

ARGUMENT

THE TAX COURT WAS CORRECT IN DECIDING THAT A PARTNERSHIP HAD BEEN HOLDING LAND FOR SALE TO CUSTOMERS IN THE ORDINARY COURSE OF ITS TRADE OR BUSINESS

A. Introduction

On November 26, 1956, taxpayer sold his partnership interest in SBIC. Normally, under the provisions of Section 741 of the Interna Revenue Code of 1954,[4/] Appendix, *infra*, the gain on such a sale woul be taxed as capital gain. However, Congress recognized that this provision could be employed by members of a partnership to convert ordinary income into capital gain. Thus, for example, if instead of selling the inventory directly, i.e., in the course of trade, which would result in the partners having ordinary income, the members sold their partnership interest, then under Section 741, the gain on the latter method would be taxed at the lower capital gains rates. To prevent such an abuse, Congress enacted Section 751, Appendix, *infra*. section provides that to the extent that the gain on the sale of the partnership interest is attributable to substantially appreciated inventory, then to that extent, the gain will be taxed as ordinary income. In the instant case, all the parties agree that under the formulas contained in Section 751(d)(1)(A) and (B), the land is substantially appreciated. However, the point in dispute is whether or not the land constituted inventory of the partnership. Inventory

4/ All references are to the 1954 Code, unless otherwise stated.

fined (Section 751(d)(2)(a)) as property described in Section 1221(1), d when reference is made to this latter section, it becomes apparent at this case involves a question which has given rise to much tigation: namely, whether property was being held for sale to stomers in the ordinary course of taxpayer's trade or business.

In the case at bar, the Tax Court found (I-R. 134) that the nd held by SBIC was property held for sale to customers in the dinary course of its trade or business, i.e., inventory for rposes of Section 751. This being a question of fact, the narrow sue on appeal is whether this finding was "clearly erroneous." llingwood Corp. v. Commissioner, 190 F. 2d 263, 265 (C.A. 9th); chards v. Commissioner, 81 F. 2d 369, 370 (C.A. 9th); Yara gineering Corp. v. Commissioner, 344 F. 2d 113 (C.A. 3d); Broughton Commissioner, 333 F. 2d 492 (C.A. 6th); Coffey v. United States, 3 F. 2d 945 (C.A. 10th); Tidwell v. Commissioner, 298 F. 2d 864 .A. 4th). If not, then, in accordance with the usual standards of view, it is entitled to finality. Commissioner v. Duberstein, 363 S. 278.

B. The partnership acquired and held the land primarily for sale to customers in the ordinary course of its trade or business

In determining whether or not property was being primarily held for le to customers in the course of business, each case must stand on s own facts. However, because of the elusive nature of the question, e courts have developed guidelines in attempting to answer this estion. These guidelines include: solicitation, amount of sales, vertising, and length of time the property was held. Taxpayer tes (Br. 13) that all of these "normal criteria" are lacking here

the instant case. But this case is unlike the usual case in that here the land was never sold by partnership (with the exception of 500 acres), and, obviously, the guidelines would be of no assistance. Thus in the usual case, a taxpayer has or has not employed agents, advertised, subdivided, etc., in the course of selling his land. These facts (or lack of them) are then on the record and the trier of fact, by employing the guidelines, can conclude whether the property was simply an investment that was being realized (sold) or whether the property actually had been held for sale and sold to customers in the course of business. But as noted, here the partnership did not engage in direct sales efforts and thus, of course, all of the "normal criteria" would be lacking. However, merely because the facts here preclude the use of these guidelines does not mean that the question as to taxpayer's primary purpose cannot be determined or that the question must, as a matter of law, be resolved in taxpayer's favor; rather, taxpayer's primary purpose in holding the land is simply more difficult to determine. Accordingly, what was said at the outset, namely, that each case in this area rests on its own facts, has particular importance in the case at bar. We submit that when all the facts of this case are examined, it is clear that from beginning to end, the partnership's primary purpose in acquiring and holding this land was for sale to customers in the ordinary course of its business.

Prior to selling the land to SBIC, the then-owner, Kensington Heights Company, had, with taxpayer's assistance, made extensive effort to sell the raw acreage to subdividers and developers. These efforts proved fruitless, the reason being (in taxpayer's words) (II-R. 47):

> Too far in the future. Wasn't ready for development. Market couldn't absorb--too expensive on account of the off-site work. In other words, there was too much other property as close or closer-in that was more economical to develop and adjacent to the utilities that would be just continuing on with their present development. They were not interested in developing a new area. (Emphasis supplied.)

ensington, unable to sell the land, then offered it to taxpayer ho, together with Berger, decided to form SBIC. Kensington's terms f purchase were rejected and SBIC submitted its plan for financing he purchase. (II-R. 50.) All the negotiations were conducted by erger who indicated that the entire area would be developed as soon s possible and that the purchase price would be paid off in about hree years. (I-R. 118-119.) Because it had been unable to sell the and to developers because of the lack of off-site improvements and ecause, as will be discussed below, the financing arrangement had to e predicated on development, it appears that Kensington wanted to nsure that development of the area would in fact take place for it, ensington, inserted in the purchase agreement a requirement that SBIC ould deposit $200,000 in escrow for off-site improvements. As the ax Court observed (I-R. 139) "This is a peculiar requirement for a eller to impose in a mere sale of acreage. Granted that such sum ould not cover off-site improvements for the entire 4,500-acre tract, he imposition of such requirement mirrors the vision of development hich the parties, including SBIC, had in mind."

As mentioned above, Kensington, by inserting the $200,000 depos requirement, was attempting to insure that development would take place. It appears that the reason for Kensington wanting development was that its financing arrangement with SBIC clearly was predicated on the assumption that the purchase price would come from the proceeds of a development. Thus the total consideration was $4,676,666.66 (including interest), with $100,000 down and 20 annual installments. The first installment of $180,000 was to be paid one year after the purchase and each of the remaining installments would be increased by $6,000 until the 19th payment of $288,000. The 20th installment would be in the amount of the balance, $130,666.66. (I-R. 119.) It w contemplated that the proceeds from the sale of 500 acres to LMDC would pay the first 5 installments. This would mean that approximatel $3,500,000 still remained to be paid from that point on. Taxpayer's response as to how this large balance was to be paid was (II-R. 73) that there were no definite plans as to how this would be done but it would be taken care of when the need arose. 5/ The Tax Court rejected

5/ Actually taxpayer suggested that, assuming the land increased, SBIC could borrow against the land. We submit that this is completely unlikely for even if the land did increase, it would be already burdened with a $3,500,000 deed of trust and it is difficult to envision who would lend money against such collateral. Moreover, even if other loans could have been obtained, where was the capital to come from to pay this added indebtedness?

As for taxpayer's other possible source of funds, i.e., contributions from the partners, this is extremely doubtful. Berger had been able to raise no more than $30,000 of his $100,000 share for the down payment and taxpayer had to guarantee Berger's loan of $30,00 Thus he hardly could be relied upon to contribute anything substantial towards a $3,500,000 debt. Furthermore, although some of the partners were wealthy men, to raise the $3,500,000 would have meant that they would have had to liquidate all their other assets, including business interests, and devote all of the capital to a tract of undeveloped land. This too, we submit, is hardly a likely assumption on which to contract a $3,500,000 debt; especially when there was no agreement by

this highly unlikely arrangement, concluding instead (I-R. 139):

> The lower payments in the earlier years seem to us more likely to reflect the understanding of the parties that development would be the generating source of the funds rather than, as petitioner suggests, the desire of SBIC to hold down the amounts required to be paid until it had had an opportunity to realize on the anticipated appreciation in value.

Moreover, in an attempt to raise the $200,000 deposit, a letter was sent to General Petroleum Corporation seeking to have that corporation lend the necessary funds. The letter stated that a master plan for the entire 4,500 acres was being completed; that it was proposed to start development of 2,000 homes; and that a minimum of 4,000 homes would be completed and occupied within three years and following this, consideration would be given to subdividers capable of proceeding with the development in a satisfactory manner. Although General Petroleum declined to provide the funds, this letter is further evidence that development of the entire tract was being planned.

All of the foregoing discussion amply demonstrates that SBIC was hardly planning, as taxpayer contended (II-R. 71-72), to purchase the land, do nothing with it for 10 years, and at that time consider what to do with it. Rather, these facts indicate quite strongly that development was the primary purpose of acquiring the land. Indeed, in light of the financing arrangement with Kensington, it appears that development was a virtual necessity. We submit that had nothing further occurred other than taxpayer selling his interest in SBIC, these facts alone would have justified a finding by the Tax Court that SBIC had acquired and held the land for sale to customers in the

ordinary course of business. As for the later developments, these, as will be shown, confirm that SBIC held the land for sale, not for investment.

As indicated, SBIC's purchase of the land was clearly predicated on the assumption that the tract would be developed. Because of his efforts on behalf of Kensington Heights Company, taxpayer knew that none of the developers operating in the area were interested in this tract. SBIC could not develop the tract due to taxpayer's desire not to "directly * * * engage in subdividing and developing the land, either individually or through any other business form, because it would place him in competition with his clients and those of his engineering partnership and thus be financially injurious." (I-R. 132.) This fact makes it readily apparent that a solution had to be found whereby development, which had to be done to generate funds for the annual payments, could be insured and possibly regulated by SBIC and yet somehow not reveal taxpayer's role in that function. We submit that the problem was solved by the creation of LMDC. Taxpayer objects (Br. 13-15) to relating LMDC's activities to SBIC, as the Tax Court did, on the grounds that there was no showing that there was any common control of these two entities. However, as will be shown, there were sufficient common interests in these two entities--either through direct ownership or because of financial considerations--so as to justify relating their interests.

Despite that it partakes of a labyrinth, the record does reveal ust how inter-related LMDC and SBIC were. All of LMDC's stock was eld in trust by Herbert Glaser, as trustee for the corporations which ade on the Country Club Park [6/] joint venture. (I-R. 121, II-R. 257-58.) It appears that the members of the Country Club Park joint enture were: Sam Glaser; Jack, Charles, and Sam Barenfeld; Herbert laser; and Herbert Glaser's grandfather. Sam Glaser was Herbert's ather and the three Barenfelds were uncles of Herbert. (II-R. 255-56.) As for the corporations, Sam Berger held a 20% interest in each nd Herber Glaser held a 10% interest in each. (II-R. 257.) Insofar s the Barenfelds and the Glasers controlled the joint venture, we ubmit that it is a fair and reasonable assumption that they held ufficient interests in the various corporations so as to control them.

Looking at the ownership interests in SBIC, it is apparent that, ith the exception of Freeland and Lowthian (who together owned 40% f the partnership), all the effective interests in SBIC were held by ersons directly involved in LMDC. Thus Berger held at 20% general artner interest and had control of 20% of the limited partnership nterest (as trustee for the HAB and MLB trusts). (I-R. 124.) Berger as also president of LMDC. (I-R. 121, II-R. 258.) The remaining 20% as held by Lake Murray Trust No. 1, which originally consisted of ack Barenfeld and Sam Glaser, but these two gave a 10% interest to he other members of the Country Club Project. (I-R. 124.) Moreover,

6/ Sometimes in discussing the Country Club Park joint venture, eference is made to Chula Vista. It appears that Chula Vista is location (development) in California where the Country Club Park oint venture was building houses. (II-R. 255-256.)

SBIC's Limited Partnership Agreement provided that in the event of policy differences between the general partners, a board of arbitration would be convened. Of the two specified arbitrators (who would choose the third), one was Herbert Glaser, who, of course, as trustee, had complete control over LMDC. (Pltf. Ex. 15, p. 8.)

Taxpayer's lack of ownership in LMDC is readily explained by his desire not to compete directly with his other clients in development. Insofar as Lowthian was taxpayer's private secretary in his engineering work and his nominee in SBIC, presumably this was why she also was not a stockholder in LMDC. However, it does not follow that taxpayer had no interest in LMDC's affairs for he apparent was to receive a fee from LMDC of $25 per lot (I-R. 130), plus his engineering partnership was employed by LMDC (I-R. 126). It is possil that taxpayer hoped that as consultant to LMDC and through his engineering partnership, he could exercise some control of LMDC's affairs, even though not a stockholder.

Clearly then, taxpayer's contention that there was no common control is to insist upon the formality that taxpayer and Lowthian, for example, had to be stockholders of record in LMDC; "But the tax law deals in economic realities, not legal abstractions * * *." Commissioner v. Southwest Expl. Co., 350 U.S. 308, 315; Weinert's Esta v. Commissioner, 294 F. 2d 750 (C.A. 5th).

Once the interlocking relationship of the two entities is recognized, it makes it relatively simple to understand other facts of this case. Thus it is easy to see why, in the original plan between LMDC and SBIC, the latter guaranteed that the cost of off-site improvements would not exceed $200,000 [7/] and that its cost of the homes to be constructed and sold would not exceed fixed amounts. (I-R. 143.) As the court stated (I-R. 143): "Such undertakings are unusual on the part of a pure seller of acreage and are indicative of a plan for the partners of SBIC to be involved in active development."

Also to be remembered is that taxpayer testified (II-R. 73) that the sale of 500 acres to LMDC would generate sufficient income to pay for the first 5 or 6 annual installments. To purchase the land on this basis, it is obvious that SBIC had to be sure that LMDC would purchase 500 acres. (LMDC had only an option to purchase which, of course, it was not required to exercise.) As the Tax Court concluded (I-R. 142-143): "These interlocking participations provided the real guarantee that the option would be exercised."

In similar fashion, the interlocking relationship explans why LMDC was able to advertise, when LMDC's model homes were shown to the public, that a "City of Tomorrow" was to be developed on the entire

7/ The same agreement provided that LMDC deposit $200,000 for off-site improvements. (I-R. 142.) Thus SBIC was imposing the same condition on LMDC as had been imposed on it, SBIC, by Kensington Heights Company.

4,500 acres. (I-R. 127.)[8/] It also explains how SBIC, through Berger, was able to represent to Kensington that the entire purchase price would be paid in three years. (I-R. 119.) Further confirmation that Kensington was to be paid in a short period of time is found in the fact that while the SBIC-Kensington contract provided for a 20 year pay-out, SBIC's partnership agreement provided that SBIC was to have a term of 10 years. And, of course, as the Tax Court observed (I-R. 143-144):

> A further indication of SBIC's involvement in the development activities of LMDC is contained in the price at which acreage was sold to it by SBIC. The purchase from Kensington and the grant of the option to LMDC took place at the same time. Yet, LMDC was required to pay $2,000 per acre although SBIC acquired the land from Kensington at $1,037 per acre ($800 plus interest). The discrepancy in price is substantial. We recognize that a small portion of the discrepancy may reflect the fact that some of the acreage would be devoted to public purposes such as streets, parks, etc. Perhaps the acreage sold by SBIC to LMDC was more valuable than other portions of the total tract. Petitioners did not see fit to enlighten us on these scores. In our view, the circumstances strongly suggest that the price was arbitrarily arrived at as a method of siphoning off to the common participants in SBIC and LMDC a portion of the latter's profit hopefully as long-term capital gains. In this connection, we note that, while Freeland did not have an ownership participation in LMDC, he could reap his financial reward from that entity via direct personal engineering fees and fees paid in his engineering partnership.

8/ Although taxpayer contended (I-R. 127) he disapproved of such advertising by LMDC, it is interesting to note that SBIC's efforts to have the School District acquire acreage for schools, parks, and recreational purposes (I-R. 128-129), if successful, would have been a significant aid towards the creation of a "City of Tomorrow" on the tract. At the very least, SBIC's efforts, again if successful, would have enhanced the value of the land and such efforts cast considerable doubt on taxpayer's contention that SBIC was simply a passive holder of raw acreage (which it hoped would increase in value over a period of years).

In light of all of this evidence, it is obvious that LMDC and SBIC were working in unison to implement SBIC's primary purpose--to sell the land which would in turn be developed. Or as the Tax Court concluded (I-R. 146):

> We think that, from the beginning, the partners in SBIC intended to sell off the property as quickly as the area could be made ready for development and that to this end they planned actively and continuously to participate in sequential development efforts. LMDC was the primer for the entire project. It was the first vehicle to be utilized and the partners of SBIC were deeply involved in the activities of that entity.

Taxpayer next contends (Br. 20) that even if there was an inter-relationship between the two entities at one time, this relationship ended when LMDC became insolvent.[9] With this as a stepping stone, taxpayer then contends that once the inter-relationship ended, SBIC's original plan to sell the land changed to one of investment. Taxpayer's contention lacks direction for it fails to appreciate that the decline of LMDC does not require that SBIC's

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9/ Actually, taxpayer suggests (Br. 20) that the inter-relationship ended sometime before this: either when SBIC filed notices of non-responsibility or when LMDC and SBIC entered into an amended agreement. The filing of notices of non-responsibility hardly indicates that these two entities ended their relationship--if anything, it indicates only that SBIC was attempting to maintain the fiction that its only relationship to LMDC was that it had sold land to LMDC. As for the amended agreement, all that occurred was that the purchase price to LMDC was partially reduced; LMDC's "loan" of $200,000 to SBIC was labeled a "credit"; LMDC's oral agreement to pay taxpayer $25 for his personal service and counsel was reduced to writing; and removed SBIC's guarantees of lot and off-site improvement costs. We submit that the Tax Court was correct in concluding that this modification was done in order to eliminate disputes arising out of the working relationships between SBIC and LMDC (I-R. 143) rather than being the result of "a bitter breach", as taxpayer contends (Br. 20).

purpose in holding the land had to change. Thus that SBIC intended to have the land developed in order to make sales of land is quite apparent in the record. Equally true is that SBIC was going to utilize LMDC as a vehicle to have the development get under way. LMDC began to develop but then, because of financial difficulties, it went out of business. But this does not mean that SBIC's purpose had to change--as taxpayer states--but only that SBIC might then have had to look for another developer. Stated differently, if a wholesaler is holding inventory for sale to a retailer and the retailer goes out of business, it does not follow that at that moment, the wholesaler's purpose in holding the inventory has changed, so that the wholesaler is now holding the items for investment purposes. In short, we disagr with taxpayer's contention that this fact--LMDC's demise--standing alone necessitates a finding that SBIC's purpose changed accordingly.

Moreover, the facts following LMDC's demise clearly show that SBIC did not change its purpose in holding the land.[10/] If anything, they reflect that from beginning to end, SBIC planned to sell its land

[10/] Interestingly enough, taxpayer here, although now also urging ther was a change of purpose (the argument was not made to the Tax Court) and suggesting various times at which such change occurred does not ever suggest that the change occurred on or after the date Berger sold out his interests. For this reason alone, we would urge that Morse v. United States, 371 F. 2d 474 (Ct. Cl.), wherein the Court held that there was a change of purpose following Berger's sale, has no applicat herein. However we believe a more important reason for not applying Morse would be because--in our view--that opinion is in error. If the land was inventory on the date Berger sold (as the Court of Claims appears to have held) and Berger's sale prompted the remaining partner to liquidate, then it would seem the land was still an inventory item. Stated differently, the liquidation of a partnership is not sufficient to convert inventory items into capital assets.

(continued on next page)

o developers and when the first developer (LMDC) failed, then SBIC through its partners) sold the land to another developer (Tavares). Thus LMDC's activities came to an end in May. On August 10, Berger sold his and the trust's interests. In less than a month, i.e., September 7, 1956, taxpayer entered into an option agreement with Tavares, giving Tavares the right to purchase taxpayer's and Lowthian's nterests. (Pltf. Ex. 34.) The negotiations for sale of 80% of the partnership occurring within four months from the time the purported change in purpose occurred casts considerable doubt that there ever was in fact an agreement to hold the land for investment. Also, it s difficult to believe that Berger would decide in May to hold the

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0/ (continued from previous page)

Moreover if Berger's sale is the beginning of a liquidation, then presumably SBIC would have been considered to have terminated. Section 708(b)(1), Appendix, infra. Under such circumstances, the partners would be deemed to have sold the assets rather than their partnership interests and under Section 735, Appendix, infra, the gain to the partners would have to be treated as ordinary income. In short, unless the partnership changed its purpose sometime prior to liquidation (that is, Berger's sale) then under Section 735, the land would continue to be considered as an inventory item for at least 5 years. Tibbals v. United States, 362 F. 2d 266 (Ct. Cl.) is not in conflict with the reasoning here because taxpayer there held the land as an individual and thus the law under the partnership sections would not be applicable. More important is that the change of purpose there apparently occurred some time prior to any liquidation sale which is not the situation in the instant case.

land for investment--which would mean making payments on the land but not having any income from the land--when presumably he was already in financial difficulties which necessitated his sale in Augu: To be remembered is that taxpayer claimed that SBIC would be able to finance the land without selling it (that is, while being held as an investment) either by borrowing on the appreciated value of the land or by having the various partners make contribution. Not only is the record barren of any evidence that either procedure was even discussed by the partners, but Berger's financial difficulties clearly demonstra that SBIC could hardly have purchased the land on the assumption that the partners would supply the necessary funds as required.

Furthermore, if SBIC had changed its purpose, what then accounts for taxpayer and his nominee, Lowthian, selling their interests? Although taxpayer testified that his sale was against his desires (II-R. 94), this hardly goes to answer the question why taxpayer would sell out after purportedly having decided to hold the land for investment. Insofar as taxpayer was a general partner, he could have had Berger's sale to Tavares set aside (taxpayer agreed to Berger sale as part of his, taxpayer's, sale agreement with Tavares). Also, even if Berger's sale had been accepted by taxpayer, taxpayer still was one of the two general partners and hence, could have insisted that the alleged reason for SBIC's holding the land be continued, i.e. investment.

The foregoing discloses that any contention by taxpayer that LMDC's demise brought about a change in purpose is a contention without merit. As the Tax Court stated (I-R. 136):

> Similarly, the record shows clearly that the plans of SBIC at the time of acquisition of the property continued to govern its subsequent activities so that we are not faced with a situation involving a change of purpose. 11/

This then brings us to taxpayer's last contention (Br. 21), namely, if the gain results solely from the fact that the land has appreciated in value, then the gain has to be taxed as capital gain. Taxpayer's point is not well taken for it is somewhat of a boot strap argument. Thus if the trier of fact determines that the land was simply held as an investment, then the gain is capital gain. If however, the trier of fact determines that the land was being held

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11/ Taxpayer's argument (Br. 15-16) that the property must be held for sale is really only a variation of the discussion just concluded. Taxpayer's point--which he did not urge in the Tax Court--appears to be similar to that urged in cases such as Ackerman v. United States, 335 F. 2d 521, 524-525 (C.A. 5th); Bauschard v. Commissioner, 279 F. 2d 115 (C.A. 6th). That is, the purpose for which the property was acquired is not controlling; rather, it is the purpose for which it was being held thereafter. Taxpayer here appears to be urging that SBIC may have planned to hold the land for sale before it acquired the property but once it acquired the land, its purpose changed and from that point onward it was being held for investment. Taxpayer attempts to rely on the record by noting that SBIC had to sell the land to LMDC under the option agreement and because nothing occurred thereafter, the record does not show that SBIC did not change its original purpose. Obviously the record shows no activity on SBIC's part--under the scheme of things, SBIC was awaiting the development of the 500 acres by LMDC before it would take further action and, accordingly, during the iterim, SBIC would be passive. Under such circumstances, it would appear incumbent upon the taxpayer to show that SBIC had in fact changed its purpose, not for the Commissioner to show that SBIC had not changed its purpose. Moreover, taxpayer offers no reason that would have prompted SBIC to change its purpose once it acquired the land.

for sale to customers in the course of trade, i.e., not as an investment, then taxpayer would have the Court determine if the land increased solely from outside forces (growth of a city, etc.), and if so, then the Court would have to say the land was an investment. If so, then the Court's entire inquiry as to the purpose for which the land was being held would be vitiated by this one fact. True, business activities will usually result in a higher price for the land but if a dealer bought acreage, admittedly held it as part of his inventory, making many efforts to sell, and then the land increases because a business has decided to locate nearby, then taxpayer would urge the land had not been held for sale to customers. We submit that such a conclusion would be contrary to the capital gains provisions. Even if taxpayer's analysis were correct, the fact is that the land increased because of development work, not because of appreciation. Thus Tavares stated (Dep. 19-20) that development of the 150 acres had increased the value of that land and the contiguous property as well. In other words, the work done by LMDC, which presumably included some--if not all--the off-site improvement work required by SBIC gave rise to the land's increase in value. Insofar as SBIC's agreement with LMDC virtually assured that the work would be done, the development work, although done in LMDC's name, must be attributed to SBIC. Accordingly, it is not unrealistic to say that SBIC's efforts gave rise to the increase in value.

In the final analysis, the Tax Court found that taxpayer did not carry his burden in proving that this land was not being primarily held for sale to customers in the ordinary course of business. There is

ample evidence in the record to support this finding and taxpayer has not shown it to be clearly erroneous.

CONCLUSION

For the foregoing reasons the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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NOVEMBER, 1967.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated:____________________day of____________________, 1967.

____
Marco S. Sonnenschein
Attorney

APPENDIX

nternal Revenue Code of 1954:

SEC. 708. CONTINUATION OF PARTNERSHIP.

* * *

(b) Termination.--

(1) General rule.--For purposes of subsection (a), a partnership shall be considered as terminated only if--

(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

(B) within a 12 month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

* * *

(26 U.S.C. 1964 ed., Sec. 708.)

SEC. 735. CHARACTER OF GAIN OR LOSS ON DISPOSITION OF DISTRIBUTED PROPERTY.

(a) Sale or Exchange of Certain Distributed Property.--

* * *

(2) Inventory items.--Gain or loss on the sale or exchange by a distributee partner of inventory items (as defined in section 751(d)(2)) distributed by a partnership shall, if sold or exchanged within 5 years from the date of the distribution, be considered gain or loss from the sale or exchange of property other than a capital asset.

* * *

(26 U.S.C. 1964 ed., Sec. 735.)

SEC. 741. RECOGNITION AND CHARACTER OF GAIN OR LOSS ON SALE OR EXCHANGE.

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).

(26 U.S.C. 1964 ed., Sec. 741.)

SEC. 751. UNREALIZED RECEIVABLES AND INVENTORY ITEMS.

(a) Sale or Exchange of Interest in Partnership.--The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to--

(1) unrealized receivables of the partnership, or

(2) inventory items of the partnership which have appreciated substantially in value,

shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

* * *

(d) Inventory Items Which Have Appreciated Substantially in Value.--

(1) Substantial appreciation.--Inventory items of the partnership shall be considered to have appreciated substantially in value if their fair market value exceeds--

(A) 120 percent of the adjusted basis to the partnership of such property, and

(B) 10 percent of the fair market value of all partnership property, other than money.

(2) Inventory items.--For purposes of this subchapter the term "inventory items" means--

(A) property of the partnership of the kind described in section 1221 (1),

* * *

(26 U.S.C. 1964 ed., Sec. 751.)

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include--

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

* * *

(26 U.S.C. 1964 ed., Sec. 1221.)

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle--

* * *

(3) Long-term capital gain.--The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

* * *

(26 U.S.C. 1964 ed., Sec. 1222.)